



The Dawn of a New Oil Era?

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By Robert J. Samuelson
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The interesting question about the advent of \$50-a-barrel oil is whether it signals a new era in the economics and politics of energy. To sharpen the question: have we entered a period when, owing to consistently strong demand and chronically scarce supplies, prices have moved permanently higher? We don't know, but the answer could be "yes" for at least one reason: China.

Americans consume almost 21 million barrels of oil a day, a quarter of the world total of 84 million barrels a day, reports the International Energy Agency. But China is now second at 6.4 million barrels a day, and its demand could double by 2020, various analysts told a conference held last week by the Center for Strategic & International Studies (CSIS) in Washington. Moreover, China will import most of its new needs; its domestic output is steady at about 3.5 million barrels a day. It's unclear how much China's extra demand--and that of other developing countries, especially India--will stimulate extra oil production.

Oil markets do undergo seismic shifts. Until 1974, the United States was the world's largest oil producer. Supplies were plentiful; Americans controlled their own oil prices, as Daniel Yergin explained in his 1991 book "The Prize." With surplus production capacity, the Texas Railroad Commission--which, despite its name, regulated oil--limited output to stabilize prices while maintaining a "security reserve" for times of crisis, wrote Yergin. In March 1971, the commission allowed all-out production to meet rising demand. America's oil surplus had vanished. Worldwide prices rose, and OPEC (the Organization of Petroleum Exporting Countries) became more powerful.

We could now be at a similar inflection point, where the global oil system changes dramatically. Certainly the short-term outlook already has. From 1991 to 1999, world oil demand rose annually about 1 million barrels a day, Guy Caruso, head of the U.S. Energy Information Administration, told the CSIS conference. But in 2004, demand unexpectedly jumped 2.7 million barrels a day. A third of the increase came from China, and much of that reflected electricity shortages. Unable to get reliable power, factories installed their own generators. China's regular power plants overwhelmingly use coal, but the new generators used imported diesel fuel. China could solve this problem by building

more power plants and easing rail bottlenecks that hinder coal shipments. But there will still be new sources of oil demand. China now has about 20 million cars and trucks, energy consultant James Dorian said; by 2020, it could have 120 million. (In 2001, the United States had about 230 million cars, vans and trucks.)

Higher oil demand has now strained the global production system to its limits. Spare capacity of about 1.5 million barrels a day is the lowest in 30 years, said CSIS's Frank Verrastro. Most is located in Saudi Arabia. Higher prices partly reflect fear of more supply disruptions--from terrorism, war, political upheavals, weather or accidents. In theory, higher prices should be partially self-correcting. They should dampen demand and encourage supply. But theory must always be revised for new realities. Here, there are two.

One is that in rich countries--notably the United States--rising incomes make it easier to afford higher energy prices. In the latest month, American oil demand was actually up 2 percent from a year earlier (and, yes, adjusted for inflation, today's gasoline prices are still roughly a third below levels reached in 1980 and 1981). A second reality is that big oil companies seem less willing or able to find new oil. A study by Credit Suisse First Boston reports that major companies have replaced more than half their depleted oil reserves by buying reserves from other companies or re-estimating existing reserves. In 1990, companies replaced two thirds of reserves with new discoveries. The poor performance may partly reflect the fact that 72 percent of the world's oil reserves are controlled by state-owned oil companies, says Verrastro. Private companies can often get exploration rights only on terms that involve (to them) too much risk and too little profit.

Anything could now happen to oil. Prices could drop, if the immediate fears behind today's buying don't materialize. But the long-term trends are unpromising. Global demand is rising inexorably; global supply seems less expansive. Dependence on precarious Persian Gulf oil will probably increase. The global economy remains hostage to uncertain or expensive fuel. Producing countries may become stronger, consuming countries weaker. There may be more competition among consuming nations to secure long-term supply contracts. China has already made a few such deals.

The message for Americans is simple. We import nearly 60 percent of our oil. We can't any time soon eliminate imports, but we could limit them by producing more at home and conserving more (meaning higher fuel taxes, tougher gasoline standards, smaller vehicles and more hybrid engines). That would lessen our own vulnerability and ease pressures for the rest of the world. The debate that pits greater production against greater conservation is wrong. We need both.